THE ECONOMIC IMPORTANCE OF THE COMMERCIAL PAPER HOUSE

The commercial paper houses perform a distinct function in the financial system of the United States. While in certain respects their work appears to be similar to, and competitive with, that of the commercial banks, the truth is that they render an essentially different service, one that no other financial agency is equipped to perform. The commercial paper house occupies a field of its own and has grown to be a necessary co-ordinating unit in our financial organization. It is only because the business is so comparatively young that the service it performs has not yet been clearly differentiated, in the minds of many, from that performed by the commercial banks. The tremendous growth it has had in the few decades that measure its entire history, and the constantly increasing number of banks and corporations that are availing themselves of its advantages, all indicate its vital importance in our financial system.

The general public has very little knowledge of the vast amount of credit advanced by the commercial paper houses, because the business is conducted on a strictly confidential basis both as regards the borrower and the purchaser. Moreover, there is no information available through the newspapers regarding their operations, since there are no published offerings or reports, not even to governmental agencies. When a bond or note issued is underwritten it is immediately heralded by the press. For example, the papers recently announced in headlines the great relief expressed in the Argentine at the probable consummation of its $50,000,000 loan in New York. A loan of this size is the subject of rejoicing by a nation; and yet many of the leading commercial paper houses regularly extend single credits of many millions of dollars, frequently comparable with this amount, without comment or public notice. The reports of the Federal Reserve Bank of New York show that the principal houses have had outstanding during the past three years as much as $1,200,000,000 of paper at a time, and

a monthly average for the period of over $900,000,000. The total volume of paper handled by all houses in 1920 was probably about $3,000,000,000. A better idea of this volume of credit is obtained when we realize that the volume of paper handled by the commercial paper houses in 1921 was equal to nearly 10 per cent of the loans made by the national banks of the country in that year.

THE COMMERCIAL PAPER HOUSE IS MORE THAN A BROKER

It should be understood that the commercial paper house is not a mere broker. It buys the paper outright from its clients, and thus advances the funds pending the sale of the paper to banks and other purchasers. The unsold paper at any moment of time in the hands of the brokers is being carried by the brokers' own resources. The volume of such paper on hand with the leading brokers from day to day commonly amounts to many millions of dollars. The commercial paper houses are thus quasibankers, although their primary function, of course, is to distribute paper.

HOW INTEREST RATES ARE EQUALIZED AND LOWERED

The significance of the economic service rendered by the commercial paper house may best be understood from the following consideration. This country is so large and the diversification of its industry is so great that different sections encounter different conditions simultaneously. The industrial east and the agricultural west, the temperate north and the semi-tropical south, each has its particular types of production. While the rates of interest prevailing in any one section of the country will generally be substantially uniform, because the volume of trade transactions at any given time will usually be of a fairly uniform character and intensity throughout the section, the rates of interest between sections will not, as a rule, be uniform, since the volume and intensity of intersectional trade transactions vary widely at different seasons. Take, for example, the huge movement of grain, cotton, tobacco, wool, fruit, and other seasonal commodities, from the producing areas to the primary markets. The rapid shifting of something like 40 per cent of the country's total products from one section to another in a comparatively short space of time, as occurs every year, is bound to disturb the general credit status.

The demand for money may therefore be active, with interest rates tending to be high, in one section, while it is quiet, with interest rates tending to be low, in another. The quick transfer of funds from one section to another to meet the needs of business, made possible by the commercial paper houses, results in more uniform interest rates throughout, and what is of primary significance, a lower level of rates generally than would otherwise prevail. Business men are enabled to borrow always in the cheapest market; bankers are enabled to keep their funds more continuously employed; and the capital resources of the country are thus more economically utilized.

The ready marketing of money is just as necessary as the ready marketing of any commodity. When it was recently suggested that the Chicago Board of Trade be abolished there was instantly raised the warning that there was no other means of securing a satisfactory market for our grain and that if it should come to pass it would result in unstable prices and, in many instances, in unsold crops. The commercial paper house may be said to perform a similar stabilizing function. Moreover, it furnishes a nation-wide loan market.

To illustrate, a country bank in Kansas may have idle funds in the fall of the year, which it would like to employ until the next season, and it is located in a farming community which has no other industry that can use the money. At the same time a woolen mill in Massachusetts may be in need of more money than its own banks can supply. There is every economic reason why the one should serve the other, and yet the banks have no means of their own for effecting this. We can readily see the necessity of the railroad in bringing the wheat to Massachusetts and the woolen cloth to Kansas. It is just as necessary that credit should be thoroughly distributed. Every means of facilitating its employment at the place of greatest need is a service to production.

Let us see what are the other possible means of effecting this necessary shifting of funds from one section of the country to another. The deposit, in dull seasons, of the idle funds of country banks in the reserve centers does not and cannot fully meet the credit needs. In other words, the concentration of surplus reserves

in a comparatively small number of large banks, for short periods, could not be depended upon to meet the regular requirements of the widely scattered borrowers who now use commercial paper, especially since such funds are subject to withdrawal in large amounts at any time, their unreliability being most evident in times of stress when they are needed most. During the past year banks have had to carry the loans of many of their customers throughout the year and if such loans had been based on deposits that were subject to heavy withdrawal at any moment the banks would have been seriously hampered. Country bank funds which are invested in commercial paper directly are available to business until the maturity of the paper. Furthermore, the concentration of commercial borrowing in a narrow market lacks the advantages which are apparent in a market which is country-wide, and hence more competitive, as is that furnished by the commercial paper houses.

But could not the regular banks perform the same service as that rendered by the broker, through the organization of commercial paper departments? Since banks are successful in marketing investment securities, it would seem to follow that they could also distribute commercial paper. The difference lies in the fact that a bond issue is a single piece of financing, which is placed principally among individuals, while the handling of commercial paper necessitates a permanent relationship with the borrower, and the paper is sold mainly to banks. A bank, with its associates, very frequently commands a sufficiently large clientele of individuals to form the basis of a successful investment business, whereas its clientele of banks is practically limited to its own correspondents; and it would have considerable difficulty in interesting the correspondents of other banks in the purchase of paper. Because of the traditionally confidential relationship of banks with their customers they would also hesitate to offer broadcast their customers' notes. In other words, the natural competition for business between banks of equal facilities would make them especially reluctant to offer each other excess lines of the paper of valued accounts. It is apparent that banks naturally confine themselves to their own clients and largely to their own particular territories,

and it is limitations such as these that have made the commercial paper house necessary. The broker occupies a neutral position and can reach all banks and all borrowers, in all territories, without encountering the natural competition and preferences that exist among the banks themselves.

THE COMMERCIAL PAPER HOUSE AND THE FEDERAL RESERVE SYSTEM

The service of the commercial paper house is, in a sense, complementary to that of the Federal Reserve banks. The very isolation of the banks in this country was one of the principal reasons for the establishment of the Federal Reserve System. In time of stress each bank stood practically alone, when proper co-ordination would have brought relief. We have recently seen how the Federal Reserve banks operate in assisting member banks that have encountered an excessive demand for funds. On account of the danger involved we have recognized the value of a neutral agent, like the Federal Reserve bank, that could co-operate with all banks in relieving a situation of overexpanded loans. Is it not also a matter of great importance, in properly utilizing the credit resources of the country, for a similar neutral agent to operate in the reverse manner and to find adequate employment for the funds of banks which are underloaned? This is the work that is done by the commercial paper houses, and there is no other agency in a position to do it.

From another point of view the service of the commercial paper house is similar to that rendered by the Federal Reserve banks. For example, during the past few years, the banks in our larger cities have been rediscounting heavily, while a great many country banks have had surplus reserves. The Federal Reserve banks could not bring the latter to the service of the former, at least in the absence of a highly developed discount market, which was manifestly a method of effecting relief along the most economic lines. This is exactly what the commercial paper houses did; and in this critical period more than a billion dollars of these surplus funds were thus made continuously available, without drawing upon the reserves of the Federal Reserve institutions. It is a question

whether our larger banks, unaided by the brokers, could have assumed this heavier burden and the Federal Reserve banks the proportionately larger amount of rediscounting that would have been necessary, at a time when they had about reached their minimum reserves.

In fact, the Federal Reserve bank has served to increase the importance of the broker. It has made member banks less dependent upon each other for services of all kinds, tended to obviate the necessity of their carrying large reserves with correspondents, and thus to leave them more dependent upon the broker for their investments. They have thereby augmented the value of the broker's co-operation in relieving a strained situation such as that through which we have recently been passing.

The co-operation of the broker brought relief under these conditions, not only by enlisting the surplus funds of country banks, but also by virtue of the fact that many banks that began to feel the strain had on hand purchased (commercial) paper which was paid at maturity, with no obligation on their part to renew it. Maturing loans of this nature act as a safety valve to a bank when a depression sets in suddenly, since it is given time to regulate its direct loans accordingly.

COMMERCIAL PAPER AND THE LIQUIDITY AND SAFETY OF BANK ASSETS

Under any conditions a bank will enhance the liquidity and the safety of its assets by distributing its loans as widely as possible. The commercial paper house alone affords this opportunity. Outside loans are of course especially desirable in a section of the country where one industry predominates, and where the prompt payment of loans depends upon the successful production or marketing of a single commodity. When adverse conditions prevail in such sections relief is given to local banks, also, by customers who, through brokers, are able to transfer their borrowing to easier markets.

The borrower on commercial paper is not only concerned with borrowing in the cheapest market. He also often finds it advantageous to keep his bank lines open for use in time of emergency.

Moreover, he very frequently requires, and is entitled to, more money than his own banks are able to give him, both on account of the legal limit of loans they can grant to any one corporation or firm and because of the bank's desire to distribute its loans as widely as possible. The wide distribution of paper among a multitude of banks enables any borrower to overcome this difficulty. Without the use of commercial paper huge concerns like the packing houses would find it necessary to keep bank accounts in all parts of the country.

The commercial paper houses will always be indispensable to our banking system because the banking facilities of any one section of the country cannot be made to fit exactly the credit needs of that section at all times, since they usually fluctuate widely with the seasons. The commercial paper houses may thus be regarded as banks at large, serving all sections, furnishing credit facilities to one section, where it would be unprofitable to establish additional banks permanently, and supplying loans to another where credit facilities are temporarily excessive. Since the loans of brokers furnish investment for huge supplies of funds continuously, the absence of the brokers under present conditions would mean that, in sections where there was an excess of funds, this volume of money might go into less essential and less secure forms of investment, or remain idle. A corresponding amount would have to be made available in sections where money was scarce, producing high interest rates and a demand for more banking facilities. Hence it would not be extravagant to say that the broker actually controls and furnishes banking capital and deposits, since he makes unnecessary a surplus supply, which would have to be taken from other fields of investment. The commercial paper house has grown to be an integral part of our banking system and is directly instrumental in supplying the credit needs of a considerable percentage of our current business operations.

The valuable service which the broker renders both the banks and the borrowers is apparent. The saving in interest resulting from the more uniform level of interest rates which he makes possible is shared by the borrowers who do not use the open market, as well as by those who do. The saving to banks must be measured,

not only by the increased profits resulting from the full and effective employment of their funds, but also by the losses avoided on the less secure investments into which a portion of their money would probably go if commercial paper were not available. These indirect economies are little realized by either the banks or the borrowers, and the broker himself has never attempted to take them into consideration as factors that should have a direct bearing on the compensation he receives.

THE CHEAPNESS OF THE SERVICE RENDERED

The broker's commission of $\frac{1}{4}$ of 1 per cent was probably selected, at the inception of the business, as a fair differential above the bank rate of interest. It was based on selling expense alone. But today the service of the broker involves the principle of underwriting also, and yet the commission has not been increased. Formerly the broker simply handled paper on consignment, having little or no capital invested in his business and taking no risk, but he now purchases his paper outright and has large volumes on hand at all times, so that he assumes the risk of its security as well as that of fluctuating rates. The commission, therefore, gives him little leeway for the absorption of losses.

During the recent era of high prices and high interest rates, the banks and practically all other lines of business, enjoyed increased profits, which offset, in a measure, any subsequent losses. In this period, however, although he was a vital factor in supplying the financial needs of our most essential industries, the broker's profits suffered, since his commission remained the same in the face of greatly increased costs of all kinds. He did not share in war profits, although he conspicuously shared war burdens.

In establishing his commission, originally, the broker no doubt proceeded on the theory that the borrower's money should not cost him more in the open market than at his own banks, and that if he is worthy of credit at all he should not be penalized for using a broker, who simply opens up legitimate avenues of credit. If the commission were figured on such a basis as to make his money cost him the same from either—when maintaining a 20 per cent bank balance without interest—it should range from $\frac{1}{2}$ of 1 per cent on

4 per cent money to $1\frac{1}{4}$ per cent on 7 per cent money, increasing $\frac{1}{8}$ with every advance of $\frac{1}{2}$ of 1 per cent in the market rate of interest, making an average commission of $\frac{7}{8}$ of 1 per cent, which is considerably above the present brokerage on six months' paper.

In fact, it would seem more reasonable for a bank which is compelled to purchase paper to pay a premium for the opportunity to employ its funds which might otherwise earn little or nothing, or be invested with less safety. If a bank keeps a certain portion of its funds continuously invested in commercial paper it has a choice secondary reserve, which is rediscountable at the Federal Reserve bank, while many of its own loans may be ineligible for rediscount and less secure. It is willing to go to considerable expense in soliciting and advertising to obtain its direct business, while the acquisition of its commercial paper, which is the choicest part of its loans, does not entail any cost. Most bankers realize this and do not bid for paper above the rate at which it is offered.

The competition among brokers is very keen and hence the rates at which they make their loans may be taken as standard rates, since they are arrived at in the widest market in the country. In soliciting accounts the broker must therefore demonstrate his ability to give general service, and in distributing his paper he must depend mainly upon its desirability as an investment. In their eagerness to get business some few brokers persist in granting rate concessions in purchasing and selling paper, which not only works to their detriment financially, but is wrong in principle. A bank may have some latitude in fixing the rate on its loans, but the broker is, of necessity, governed by the market rate of interest—in fact, by the rate prevailing in the easiest market in the country, since borrowers naturally seek loans in the cheapest market.

The ability of the commercial paper house to give service may best be judged by the reputation it has earned through years of operation, its financial resources, its distributing facilities, and its willingness to co-operate with its clients in every respect. The unusual degree of service which a broker may render his clients was forcibly demonstrated in many instances during the past year. A number of excellent business enterprises were seriously threatened on account of the abrupt readjustment, and in many instances,

where lack of co-operation among those at interest would have resulted disastrously, the broker, as a neutral agent, was able to work equally in the interests of the companies as well as the banks and thus to effect that harmony of action which was necessary to carry them safely through the period of liquidation.

The importance of the function which the commercial paper house performs in our financial organization may best be summarized by quoting from Professor H. G. Moulton's comprehensive work, *The Financial Organization of Society*, where, in his concluding remarks on the commercial paper house, on page 437, he states:

> The equalization of the supply of funds in the different centers, together with the fuller utilization of productive resources that is thereby made possible, is obviously not without its effect upon the cost of conducting business. It may therefore be said that the commercial paper house finds both its opportunity for obtaining profits and its social justification in the contribution that it makes to the efficient utilization of financial and economic resources in the production of wealth.

Throughout the present discussion an effort has been made to demonstrate that the unequal distribution of funds that is characteristic of this country is due, not to any defect in our banking system, but rather to natural sectional differences, along broad economic lines, that necessarily exist in a country of such vast proportions as the United States. The more or less seasonal demand for funds in the different sections occurs in regular cycles that do not synchronize with each other, and hence the commercial paper house was called into being as an equalizing medium, and has since been able to contribute many other valuable services.

WALTER MCAVOY

ST. LOUIS, MISSOURI